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Discount on issue of Employee's stock options is allowable as revenue expenditure

In brief

The Special Bench (SB) of the Income-tax Appellate Tribunal (Tribunal), Bangalore has recently delivered a landmark judgment in the case of M/s Biocon Limited¹, (“the assessee” or “the Company”) on the issue of the allowability of discount on issue of Employee Stock Option Plans (ESOP). In a detailed judgement, the Tribunal held that discount on the issue of ESOPs cannot be treated as an under-recovery of share premium or capital expenditure and held being a part of package of remuneration to employees, the obligation incurred of issuing shares at a discounted price at a future date in lieu of their services, is an allowable deduction under section 37(1) of the Income-tax Act, 1961 (the Act). The Tribunal further deliberated and ruled in detail on the timing and amount to be considered while claiming the deduction.

Facts

The assessee manufactured Enzymes and Pharmaceutical ingredients. It formulated an employee stock option plan *viz.* ESOP 2000 (with a vesting period of four years). Under ESOP 2000, the assessee granted options to its employees to purchase the shares at a face value of INR 10, whereas the market price of such shares was INR 919. Hence, the difference between the alleged market price and the exercise price, at INR 909, was claimed as a deduction on account of compensation to the employees to be spread over the vesting period of four years. During the assessment year 2003-04, the assessee claimed a deduction of INR 3,38,63,779 as “Employee compensation costs” under section 37 of the Act, which it claimed represented a discount under ESOP 2000 by placing reliance on the

¹ M/s Biocon Ltd. v. DCIT [TS-322-ITAT-2013(Bang)]

Securities and Exchange Board of India (SEBI) Guidelines² and the Chennai Bench decision on S.S.I. Limited³. The assessing officer (AO) denied the assessee's claim on the premise that there was no specific provision entitling the deduction of such expense under section 37(1) of the Act. Further, it held that the SEBI guidelines cannot supersede the taxing principles. Upon appeal, the Commissioner of Income-tax (appeals) (CIT(A)) upheld the said disallowance which then came to form the subject matter of the question before the SB after reference from the division bench.

Issues before the Tribunal

The SB of the Tribunal was formed to decide whether discount on the issue of ESOP was an allowable deduction in computing the income under the head "profits and gains of business and profession".

Revenue's contentions

The discount on ESOP was not expenditure in terms of section 37(1) of the Act, because, by issuing shares at discount, the company paid out nothing. The 'discount', representing the difference between the market price of the shares at the time of grant of options and the price at which such options were granted, would be a short capital receipt. Even if it were to be considered as expenditure, it could only be in the nature of capital expenditure. The discount was nothing but a contingent liability during the vesting period, as the options so granted could lapse during the vesting period itself if employment was terminated for an employee or if an employee chose not to exercise his option. Reliance was placed on the decision of Ranbaxy Laboratories Limited⁴ and VIP Industries Limited⁵

Assessee's contentions

The discount on issue of employee stock-options was deductible under section 37(1) of the Act as all the requisite conditions therein had been satisfied. Further,

reliance was placed on SEBI Guidelines and the decision of Chennai Bench of Tribunal in the case of S.S.I. Limited³ to fortify the claim that it was not a case of any short receipt of share premiums but of compensation given to employees. It was also submitted that the view of the Chennai Bench had been approved by the Madras High Court in the case of PVP Ventures Limited⁶ and by the Chandigarh Bench in the case of Spray Engineering Devices Limited⁷. The amount of discount claimed by the assessee was not a contingent liability but an ascertained liability based on the vesting period spread over the period of the ESOP scheme.

Tribunal Ruling

The Tribunal made various important observations and answered the question framed in three steps *viz.* (i) whether any deduction of such discount was allowable (ii) If yes, then when and how much, and (iii) whether any subsequent adjustment had to be made to the discount.

• Whether discount under ESOP is an allowable deduction?

ESOP was simply one of the modes of compensating employees for their services and hence, it formed part of employee's costs. In case of shares issued under ESOP, the primary object of a company is not to raise share capital but to earn profit by securing the consistent and concentrated efforts of its dedicated employees, and the sole object of issuing shares to employees at a discounted premium is to compensate them for the continuity of their services to the Company; in no way could this be described as either a short capital receipt or a capital expenditure. ESOP was expenditure under section 37(1) of the Act as the assessee had an obligation to issue shares at discounted rates on future dates, even if it was not paying anything to its employees. The meaning of the term "expenditure" under section 37(1) of the Act was not only "paying out" but also "incurring"⁸, and could also encompass 'loss'⁹, even though no amount was actually paid. To ascertain whether ESOP expense was a contingent liability, the Tribunal referred to the general terms of ESOP schemes and held that once the employee rendered services in the first year of

² Securities and Exchange Board of India (Employee Stock Option Scheme And Employee Stock Purchase Scheme) Guidelines, 1999 (hereinafter called 'the SEBI Guidelines' or 'the Guidelines')

³ S.S.I Limited v. DCIT (2004) 85 TTJ 1049

⁴ Ranbaxy laboratories Limited v. Add. CIT (ITA Nos. 1855 & 3387/Del/2004)(2009) (ITAT Delhi)

⁵ VIP Industries v. DCIT (ITA No. 7242/Mum/2008) (2010)(ITAT Mumbai)

⁶ CIT v. PVP Ventures Limited (19.06.2012) (Mad. HC)

⁷ ACIT v. Spray Engineering Devices Limited [ITA No. 701/Chd/2009] (22.06.2012)

⁸ Referred to definition of term "paid" under section 43(2) and 2(h) of Expenditure Act, 1957

⁹ CIT v. Woodward Governor India (P) Limited (2009) 312 ITR 245 (SC)

the relevant scheme, it became obligatory on the part of the company to honor its commitment of allowing the vesting of part of the option in that particular year. Hence, the liability stood and was incurred at the end of each year on rendition of services by the employees, even though the quantification may have taken place in a later year¹⁰.

Furthermore, options remaining unvested would be available for grant/ regrant at a future date. Liability to incur ESOP, if considered at the macro level *qua* the group of employees, as against at the micro level *qua* each individual employee, was not 'contingent' because if the options lapsed due for whatever reason, other employees would be eligible for them. The legislature considered a discount on the issue of ESOP to employees as a fringe benefit or "any consideration for employment" for the purpose of fringe benefit tax, and therefore it was not possible to argue to the contrary. Therefore, such a discount was an allowable deduction.

- **What is the timing and quantum of deduction?**

Under section 37(1) of the Act, a company following the mercantile system of accounting can claim a deduction for a total discounted premium representing employee costs over the vesting period. Incurring liabilities towards the discounted premium, which is compensation to employees, is directly linked with the span of service put in by each employee. Liability to issue stock options at discount is incurred during the vesting period and the amount of deduction is to be calculated, as per the terms of the ESOP scheme, by considering the period and percentage of vesting during this period. Hence, it was held by Tribunal that such discount was deductible over the vesting period on a straight-line basis. In effect, the Tribunal agreed with the conclusion drawn in S.S.I. Limited³.

- **Subsequent adjustment to discount**

The Tribunal observed that though the company incurred a liability during the vesting period, the actual amount of employee costs to the company could be finally determined only at the time of the exercise of the options or when the

options remained unvested or lapsed at the end of the exercise period. No deduction could be claimed in respect of those options which remained unvested or had lapsed at the end of the exercise period. Hence, any discount on unvested or unclaimed options should be reversed in the relevant year as they were not employee costs. The provisional liability for discounts which arose or were incurred during the vesting period required adjustment due to the fact that the actual discount could only be determined with respect to the market price of shares when employees exercised their options. Hence, the assessee should make a suitable downward or upward adjustment at that time.

The Tribunal rejected the method of computation of discount followed by the assessee and noted that the assessee had not made any downward adjustment in respect of the difference between the grant price and the price at the time the options were exercised. It also rejected the assessee's reliance on SEBI guidelines to the extent that it did not provide for downward adjustment. The total amount of discounting premium should be claimed evenly over the vesting period of four years, as against the claim made by the assessee that the proportionate part of the discount for the second, third and fourth years should be claimed at the end of the first year, (which ran contrary even to SEBI guidelines), and should be determined on a straight-line basis. No accounting principle could be determinative in the matter of computation of total income under the Act where it runs contrary to taxing statute. The assessee's reliance on the ruling of S.S.I. Limited³, which upheld the binding force of SEBI guidelines, was rejected. It directed the AO to verify the valuation of shares by the assessee as no material had been placed on record to support it, and also to verify the assessee's calculation of the ESOP discount.

Conclusion

The Tribunal's judgment has put to rest the controversy surrounding the allowability of discount on issue of stock options to employees in lieu of services rendered by them. The judgment also provides clarity and useful reference on the timing and amount for claiming such deduction. As the ruling has been given by the SB of Tribunal, it will be binding on all benches of the Tribunal.

¹⁰ Relied on Bharat Earth Movers (245 ITR 428) (SC) and Rotork Controls India P. Ltd (2009) (314 ITR 62)(SC).

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